

BEFORE
THE PUBLIC SERVICE COMMISSION OF
SOUTH CAROLINA
DOCKET NO. 94-396-G - ORDER NO. 95-156✓
FEBRUARY 7, 1995

IN RE:	Application of United Cities Gas)	ORDER APPROVING
	Company for an Increase in its)	RATES AND CHARGES
	Natural Gas Rates and Charges.)	

I. INTRODUCTION

This matter comes before the Public Service Commission of South Carolina ("the Commission") by way of the Application of United Cities Gas Company ("United Cities" or "the Company") filed on August 8, 1994, whereby the Company notified the Commission of proposed changes in certain rates and charges and tariff changes for the natural gas services provided by the Company in South Carolina, and whereby the Company requested Commission approval of the proposed changes. The Application was filed pursuant to S.C. Code Ann. §58-5-240 (Supp. 1993) and R.103-830, et seq. of the Commission's Rules and Regulations.

According to the Company's Application, the proposed rates and charges would have produced additional gross revenues of \$341,434 had they been in effect for the twelve month period ending March 31, 1994. The Company's presently authorized rates and charges were approved by Order No. 88-1211, dated December 1, 1988 in Docket No. 88-227-G.

By letter dated August 18, 1994, the Commission's Executive Director instructed the Company to cause to be published a prepared

Notice of Filing once a week for three consecutive weeks in newspapers of general circulation in the Company's service area. The Company was also directed to furnish, by U.S. Mail, the Notice of Filing to all customers served by the Company. The Notice of Filing indicated the nature of the Company's Application and advised all interested parties desiring to participate in the proceeding of the manner and time in which to file the appropriate pleadings. The Notice of Filing also indicated that the Commission Staff may propose implementation of a Weather Normalization Adjustment (WNA) which would adjust the future bills of residential and commercial customers up or down to reflect conditions which vary from normal weather conditions during the winter period. The Company subsequently furnished affidavits of publication and mailing which demonstrated that the Notice of Filing had been published and mailed to each customer.

Petitions to Intervene were received from the Consumer Advocate for the State of South Carolina ("the Consumer Advocate") and the South Carolina Energy Users Committee ("the Energy Users") (hereafter collectively referred to as "the Intervenors").

Pursuant to notice given in accordance with the applicable provisions of law and the Rules and Regulations of the Commission, a public hearing was held commencing on January 4, 1995, at 10:30 a.m., with the Honorable Guy Butler, Vice-Chairman, presiding. Appearances were entered by John E. Schmidt, III, Esquire, and Jerry W. Amos, Esquire, on behalf of the Company; Elliott F. Elam, Jr., Esquire, on behalf of the Consumer Advocate; Dean B. Bell, Esquire, on behalf of the S.C. Energy Users; and Florence P.

Belser, Staff Counsel, on behalf of the Commission Staff.

The Company presented four (4) witnesses on its behalf: (1) Gene C. Koonce, President, Chief Executive Officer, and a Director of the Company; (2) Patricia D. Jackson, Senior Manager of Rates in the Regulatory Affairs Department; (3) James G. Sager, Senior Manager of Accounting/Regulatory Affairs; and (4) Dr. Donald A. Murray, Economist with C. H. Guernsey & Company, Oklahoma City, Oklahoma.

The Commission Staff presented three (3) witnesses: (1) Brent L. Sires, Utilities Rate Analyst; (2) Steve W. Gunter, Utilities Accountant, and (3) Dr. James E. Spearman, Assistant Public Utilities Economist.

In consideration of the evidence in the record before us, the Commission has remained mindful of our statutory responsibility, delineated by S.C. Code Ann., §58-5-210, et seq. (Law Co-op. 1976), as amended, to determine the lawfulness and reasonableness of rate adjustments proposed by public utilities. In the due exercise of its responsibility and for the reasons more fully discussed herein, the Commission has determined that a rate of return on equity of 11.75% to 12.00% including flotation costs, with rates being set at 11.75% on equity including flotation costs, and an overall rate of return on rate base resulting from the Company's gas operations of 10.73%, based on adjusted test year operations, is fair and reasonable. In order to have the opportunity to achieve an overall rate of return on rate base of 10.73%, the Company would have required additional annual revenues of \$252,645. Founded upon the Company's test year operating and financial experience as adjusted,

the Commission has concluded that the allocation of the additional revenue, as provided herein, meets the applicable statutory criteria and is consistent with other pertinent legal pronouncements. Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 2d 333 (1944); Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia, 262 U.S. 679, 43 S.Ct. 675, 67 L.Ed. 1176 (1923); Southern Bell Telephone and Telegraph Co. v. Public Service Commission of South Carolina, 270 S.C. 590, 244 S.E.2d 278 (1978).

II. THE COMPANY

United Cities is incorporated under the laws of the States of Illinois and Virginia and is duly authorized by its Articles of Incorporation to engage in the business of transporting, distributing and selling natural gas. It is duly domesticated and is engaged in conducting the business above mentioned in the States of South Carolina, Tennessee, Virginia, Illinois, Georgia, Kansas, Iowa, and Missouri. It is a public utility under the laws of South Carolina, and its public utility operations in South Carolina are subject to the jurisdiction of this Commission. See, S.C. Code Ann. §58-3-140(A) (Law. Co-op. 1976 & Supp. 1993). During the test year, the Company served approximately 297,000 customers in its eight (8) state service area. Of these customers, approximately 5,000 customers, or two percent (2%) are located in the city of Gaffney and Cherokee County, South Carolina.

III. TEST YEAR

A fundamental principle of the ratemaking process is the establishment of a test year period. Ideally, such a period should

be represented by the most recent twelve months preceding the date of filing a rate adjustment application for which data is available. While the rates and charges finally approved will have prospective effect only, this Commission has routinely adhered to the view that the immediate past experience, characterized by identifiable operating results for a complete twelve month period, provides the most reliable guide for the immediate future. The reliance upon the test year concept, however, is not designed to preclude the recognition and use of other historical data which may precede or postdate the selected twelve month period.

Integral to the use of an average test year, representing normal operating conditions to be anticipated in the future, is the necessity to make normalizing adjustments to the historic test year figures. Only those adjustments which have reasonable and definite characteristics and which tend to influence reflected operating experience are made to give proper consideration to revenues, expenses, and investments. Southern Bell, supra, 244 S.E.2d at 284. Adjustments may be allowed for items occurring in the historic test year but will not recur in the future; or to give effect to items of an extraordinary nature by either normalizing or annualizing such items to reflect more accurately their annual impact; or to give effect to any item which should have been included or excluded during the historic test year.

In the instant proceeding, the Company's Application was based on actual operating experience for the twelve month period ending March 31, 1994, and included financial and operating information for that period. The Commission Staff likewise presented its

evidence within the context of the same test period. In consideration of the relative proximity of the commencement of this proceeding, the Commission finds the twelve months ended March 31, 1994, to be a reasonable period for which to make our ratemaking determination herein.

IV. ACCOUNTING AND PRO FORMA ADJUSTMENTS

Certain adjustments affecting revenues and expenses were included in the exhibits and testimony offered by the witnesses for the Company and the Commission Staff. This Order will discuss in detail only those accounting and pro forma adjustments which represented differences in regulatory treatment of the respective items. The Company, for purposes of ratemaking in this case, accepted all but two of Staff's recommendations.

A. Annualization of Operating Revenues for Current Rates

To reflect the year end level of operating revenues, the Commission Staff and the Company proposed an adjustment in the amount of \$1,611,019 to Per Book Operating Revenues. The Consumer Advocate and the Energy Users did not oppose this adjustment. The Commission finds the adjustment proposed by the Commission Staff and the Company to be appropriate for our ratemaking determinations herein, and adopts the adjustment.

B. Annualization of Payroll Expenses.

The Commission Staff and the Company propose to annualize payroll expenses. The Company proposed to increase payroll expenses by \$14,132. The Commission Staff proposed an adjustment of \$105. At the hearing, the Company accepted the Commission Staff's adjustment, and the Consumer Advocate and the Energy Users

did not contest this adjustment. The amount included by Staff, and accepted by the Company, is known and measurable since it represents the annual payroll at the level actually in effect as of the Staff's audit. The Commission concludes that the Staff's adjustment is appropriate.

C. Incentive Pay Plan

The Company proposed inclusion of its incentive compensation plan in its operating expenses. The Staff rejected the Company's proposal to adjust payroll by \$10,863 for incentive pay. The Company presented evidence at the hearing regarding the incentive pay plan. According to the Company's testimony, the purpose of the incentive pay plan is to recognize, reward, and encourage employees for their contributions to the success of the Company. The incentive pay plan is primarily based on performance, and each participant is measured by no fewer than 3 and no more than 6 specific performance measures. (Rebuttal Testimony of Sager, and Hearing Exhibit No. 10.) Company witness Koonce also testified that it is apparent that the plan generates a high level of enthusiasm and keen interest in tracking the various cost and performance measures within control of the group. Mr. Koonce also testified that the plan is a modest one that has been found to be reasonable by the Liberty Consulting Group. (Rebuttal Testimony of Koonce, p. 2). While this Commission has previously rejected incentive pay plans which rewarded management personnel only, the Commission believes and so finds that the incentive pay plan of United Cities is reasonable and appropriate for ratemaking purposes herein. The Commission believes that the customers will derive

benefit from the enhanced performance of the managers which this incentive pay program encourages. The conservative payouts and modest nature of this incentive pay plan benefit the Company and the consumer. Therefore, the Commission adopts the Company's adjustment .

D. Annualization of Gas Cost

The Commission Staff and the Company propose to annualize gas cost. The Company proposed to annualize gas cost at \$1,572,984. The Staff proposed an adjustment of \$1,577,832. The Company agreed to Staff's adjustment at the hearing. Neither the Consumer Advocate nor the Energy Users contested the adjustment. The Commission finds the adjustment proposed by the Staff to be appropriate for ratemaking determinations herein and hereby adopts Staff's adjustment.

E. Bad Debt Expense

Both the Company and the Staff proposed to increase bad debt expense for the annualized gas revenue adjustment. The Company's adjustment was \$2,093; the Staff's adjustment was \$1,288. Staff computed its adjustment based on a five year average of uncollectibles as a percentage of gas revenues applied to Staff's adjustment to annualize gas revenues to a year-end level. The Company accepted Staff's adjustment at the hearing. As the Commission adopted Staff's adjustment to annualize gas cost to year end level, the Commission adopts Staff's adjustment to bad debt expense and hereby finds Staff's adjustment appropriate for ratemaking purposes.

F. Rate Case Expenses

Staff amortized rate case expenses, as provided by the Company during Staff's audit, over a three year period. Staff's adjustment totaled \$4,868. In its filing, the Company estimated rate case expenses to total \$54,000 and proposed an adjustment of \$18,000. At the hearing, the Company updated its rate case expenses and supplied the Staff with bills for rate case expenses totaling \$56,434. Based on the updated expense figure, the Company proposed that the proper amount of rate case expenses to be intended in this case is \$18,811. Staff testified that the updated rate case expenses were expenses that Staff would have allowed had the expenses been incurred at the time of Staff's audit. The Commission finds the Company's adjustment appropriate as to rate case expenses.

G. Employee Hospitalization and Medical Insurance Expense

The Company and the Staff proposed to increase employee hospitalization and medical insurance. By its filing the Company proposed an increase of \$26,527; the Staff proposed an adjustment of \$5,069. Staff annualized medical, hospital and life insurance expense using the average annual rate per employee at July 31, 1994, times the average number of employees at July 31, 1994. At the hearing the Company accepted Staff's adjustment, and the Consumer Advocate and the Energy Users did not contest Staff's adjustment. The Commission finds the amount proposed by Staff to be appropriate for ratemaking purposes herein and hereby adopts same.

H. Pension Costs

The Company proposed an adjustment of \$2,504 to annualize pension costs to a year-end level. The Staff proposed an adjustment of \$6. Staff computed its adjustment using the annualized payroll expense adjustment times the actual net periodic pension expenses percentage of actual payroll excluding propane operations. The Company accepted Staff's adjustment at the hearing. The Intervenors took no issue with Staff's proposed adjustment. The Commission finds the Staff's adjustment to be appropriate for ratemaking purposes herein and hereby adopts same.

I. Employee Benefits Expense

The Staff and the Company proposed adjustments to annualize employee fringe benefits for the payroll adjustment. The Company's adjustment was \$1,650, and the Staff's adjustment was \$10. Staff's adjustment was computed using the actual employee benefit costs percentage of actual payroll times the annualized payroll adjustment. The Company accepted Staff's adjustment at the hearing. As the Commission adopted Staff's adjustment for the payroll adjustment, the Commission adopts the corresponding adjustment with respect to the employee benefits expense. Therefore, the Commission finds Staff's adjustment to be appropriate.

J. Annualization of IRP Costs

The Staff and the Company proposed adjustments to amortize Integrated Resource Plan (IRP) costs. Staff's adjustment was \$21,965; the Company's adjustment was \$23,333. Staff computed its adjustment by using the actual IRP costs incurred as of September

1994 and amortized that amount over a three year period. The Company agreed with Staff's adjustment at the hearing. Neither the Consumer Advocate nor the Energy Users took exception with Staff's adjustment. Therefore, the Commission adopts Staff's adjustment.

K. Annualization of Public Liability and Other Insurance Costs

Both the Staff and the Company proposed to annualize public liability and other insurance costs. The Staff proposed an adjustment of \$3,142 which the Company accepted at the hearing. The Commission finds Staff's adjustment appropriate for ratemaking purposes herein and hereby adopts Staff's adjustment.

L. Nonallowable Expenses

Staff proposed an adjustment of (\$4,172) to eliminate nonallowable expenses. Staff reviewed the books and records of the Company on a sample basis and eliminated items which the Commission has routinely classified as being nonallowable for ratemaking purposes. These nonallowable items included institutional advertising, employee gifts and awards, contributions, athletic club dues, and one-half ($\frac{1}{2}$) of Chamber of Commerce dues. At the hearing, the Company accepted Staff's adjustment, and neither the Consumer Advocate nor the Energy Users contested the adjustment. The Commission finds the Staff's adjustment appropriate for ratemaking purposes and adopts same.

M. Annualize Depreciation

The Staff and the Company proposed to annualize depreciation expense on year-end "Plant in Service." Staff's adjustment totaled \$45,496, and the Company's adjusted totaled \$43,632. At the

hearing, the Company accepted Staff's adjustment and neither the Consumer Advocate nor the Energy Users took issue with the adjustment. The Commission finds Staff's adjustment appropriate for ratemaking purposes herein and hereby adopts Staff's adjustment.

N. Amortization of Investment Tax Credit

Staff proposed an adjustment of (\$13,282) to correct a mistake in "Per Books" amortization of Investment Tax Credit (ITC). The Company accepted Staff's adjustment at the hearing. The Commission finds Staff's adjustment appropriate and hereby adopts Staff's adjustment.

O. Interest Synchronization

The Staff and the Company proposed an adjustment to recompute the test year state and federal income taxes to reflect the tax effect of the interest synchronization to the capital structure and annualized interest on customer deposits. The Staff's adjustment totaled (\$1,610); the Company proposed an adjustment of (\$163). The Company accepted Staff's adjustment at the hearing. The Commission adopts Staff's adjustment as appropriate.

P. Interest on Customer Deposits

The Company and the Staff both proposed adjustments to interest on customer deposits based on the March 31, 1994 balance in the account. The Company's adjustment was \$4,634 while Staff's adjustment was (\$195). The difference in the proposed adjustment is due to Staff's use of the current Commission approved interest rate of 8%. At the hearing, the Company accepted Staff's adjustment. The Commission hereby adopts Staff's adjustment.

Q. Update Plant in Service

Staff proposed to update "Plant in Service" to July 31, 1994. This update required the depreciation expense annualization of the added plant in service and the elimination of the balances in the "Allowance for Funds Used During Construction" account. Staff's adjustment totaled \$6,705 to "Depreciation Expense" and (\$1,596) to "Allowance for Funds Used During Construction." At the hearing, the Company agreed with Staff's adjustments, and the Intervenor did not take issue with these adjustments. The Commission finds Staff's adjustments appropriate for the ratemaking purposes herein and adopts Staff's adjustments.

R. Income Taxes

Staff proposed an adjustment of (\$813) to Income Taxes to correct "Per Books" income tax expense using current tax rates applied to taxable income. The Company used a 5½% state tax rate, and Staff used the current tax rate of 5%. The Company agreed to Staff's adjustment at the hearing. The Commission accepts and adopts Staff's adjustment.

S. Customer Growth

The Company and the Staff both proposed to adjust "Customer Growth" for the effects of accounting and pro forma adjustments. At the hearing, the Company agreed with Staff's adjustment of \$3,099. The Commission hereby adopts Staff's adjustment to customer growth for the effects of accounting and pro forma adjustments.

T. Taxes

The Commission has adjusted general taxes and state and federal income taxes to reflect all adjustments herein approved.

U. Other

All other adjustments proposed by the Staff and not objected to by any party have been considered and are approved.

V. RATE BASE

While there is no express statutory requirement that the Commission determine the value of a gas utility's property devoted to the public service and give appropriate consideration to such property in the context of a ratemaking proceeding, this Commission has traditionally and consistently done so in general ratemaking proceedings involving gas utilities.

For ratemaking purposes, the rate base is the total net value of the gas utility's tangible capital or property value on which the gas utility is entitled to earn a fair and reasonable rate of return. The rate base, as derived in this proceeding, is composed of the value of the Company's property used and useful in providing gas service to the public, materials and supplies, and an allowable for cash working capital. The rate base computation incorporates reductions for accumulated depreciation, customer advances for construction, customer deposits, accumulated deferred income taxes, and unclaimed funds.

In accordance with its standard practice, the Accounting Department of the Commission Staff conducted an audit and examination of the Company's books and verified all account balances from the Company's General Ledger, including rate base

items, with plant additions and retirements. On the basis of this audit, the pertinent hearing exhibits and the testimony contained in the record of the hearing, the Commission can determine and find proper balances for the components of the Company's rate base as well as the propriety of related accounting adjustments.

When the rate base has been established, the Company's total operating income for return is applied to the rate base to determine what adjustments, if any, to the present rate structure are necessary to generate earnings sufficient to produce a fair rate of return. The rate base should reflect the actual investment made by investors in the Company's property and the value upon which stockholders will receive a return on their investment.

This Commission's determinations relative to the Company's rate base for its gas operations appear in the following subsections:

A. Plant-in-Service

The Commission has traditionally used the regulatory accounting methodology recognized as "original cost less depreciation" in the determination of the value of a gas utility's plant in service. In its filing, the Company included per book plant in service of \$7,116,770. The Staff included per book plant in service of \$7,116,770, plus the following adjustments: \$163,104 to reflect plant additions actually occurring through July 31, 1994; \$6,705 to Accumulated Depreciation in connection with the adjustment to annualize "Depreciation Expense" for the update of "Plant in Service"; (\$9,041) to "Construction Work in Progress" to reflect the updated "Plant in Service" to July 31, 1994; (\$45,496)

to "Accumulated Depreciation" for the effect of the adjustment to annualize Depreciation Expense on year-end Plant in Service; \$1,456 to "Cash Working Capital" to correct entries and to eliminate the minimum bank balances from the computation; and \$5,499 to adjust "Accumulated Deferred Income Taxes" for the effect of the flowback of the excess accumulated deferred federal income taxes to ratepayers. At the hearing, the Company agreed to the Staff's plant in service amount. The total plant in service amount proposed by the Staff and agreed to by the Company is \$7,279,874.

B. Accumulated Depreciation

In determining the proper rate base for gas utilities, the Commission uses gross plant in service dedicated to providing public service as reduced by the reserve for depreciation and amortization. The reserve represents that portion of the utility's depreciable properties which has been consumed by previous use and recorded as depreciable property. The Staff's per book accumulated depreciation was (\$2,823,632). The Staff proposed to adjust accumulated depreciation by (\$52,201) as a result of annualizing depreciation expenses to reflect test year-end plant balances and plant additions through July 31, 1994. At the hearing, the Company agreed with the Staff's adjustments. The Staff's adjustments for depreciation are consistent with the other adjustments set forth above. Therefore the Commission concludes that the proper amount of accumulated depreciation to be included in the Company's rate base is (\$52,201). Hearing Exhibit 19, Accounting Exhibit A-5.

C. Construction Work in Progress

This Commission has traditionally considered the reasonable and necessary costs of construction of utility plant not yet in service to be a proper rate base item. Such costs are described as "construction work in progress" (hereinafter "CWIP"). As Staff proposed to update plant in service to July 31, 1994, which the Commission adopted above, the Staff proposed to eliminate the balance in CWIP which resulted in a reduction of (\$9,041). As the Commission approved the update to plant in service to July 31, 1994, the Commission also finds the corresponding adjustment to CWIP to be reasonable.

D. Materials and Supplies

The Commission has traditionally considered "materials and supplies" to be a proper item to be included in a gas utility's rate base. In the instant proceeding, the per book amount for materials and supplies was \$1,349,693. No party proposed any adjustment to this amount; therefore, the Commission finds \$1,349,693 to be the appropriate amount for materials and supplies in this proceeding.

E. Cash Working Capital

The Commission Staff and the Company both proposed to adjust "Cash Working Capital." The Commission Staff proposed an adjustment of \$1,456 which related to correcting entries and the elimination of minimum bank balances from the computation. The Company proposed an adjustment of \$13,065 which related to the effect of accounting adjustments. The Company agreed to the Commission Staff's adjustment at the hearing, and the Intervenor

did not take issue with this adjustment. The Commission accepts Staff's adjustment as appropriate. The Commission considers an allowance for working capital to be appropriate for inclusion in the rate base for a gas utility. By permitting a working capital allowance, the Commission acknowledges the requirement for capital outlay related to the routine operations of a utility.

F. Accumulated Deferred Income Taxes

The accumulated deferred income taxes constitute a form of cost-free capital, and, consequently, an element upon which the Commission feels investors are not entitled to earn a rate of return. Staff proposed an adjustment of \$5,499 to adjust "Accumulated Deferred Income Taxes" for the effect of the flowback of the excess accumulated deferred federal income taxes to ratepayers. The Company accepted Staff's adjustment at the hearing, and the Consumer Advocate and the Energy Users did not take issue with the adjustment. The Commission accepts Staff's adjustment.

G. Customer Deposits

The amount representing customer deposits also is considered by this Commission to be an element on which the Company's investors are not entitled to earn a return, and which should be excluded from the Company's rate base. In the instant proceeding, the per book amount of customer deposits was (\$120,714). No party proposed any adjustment to this amount; therefore, the Commission finds (\$120,714) to be the appropriate amount to be excluded from rate base attributable to customer deposits.

H. Contributions in Aid of Construction

The item of contributions in aid of construction represents an additional component upon which the Commission considers investors are not entitled to earn a return. In this proceeding, the per book amount for contributions in aid of construction is (\$45,202). No party proposed any adjustment to this amount; therefore, the Commission finds (\$45,202) to be the appropriate amount to be deducted from the Company's rate base for contributions in aid of construction.

I. Original Cost Rate Base

The Company's rate base for its gas operations as herein adjusted and determined by the Commission to be appropriate for the purposes of this proceeding, is set forth in the following table:

Table A
ORIGINAL COST RATE BASE
MARCH 31, 1994

Gross Plant in Service	\$ 7,279,874
Less: Accumulated Depreciation	<u>(2,875,833)</u>
Net Plant	4,404,041
Construction Work in Progress	0
Materials and Supplies	1,349,693
Cash Working Capital	69,936
Accumulated Deferred Income Taxes	(411,511)
Customer Deposits	(120,714)
Contributions in Aid of Construction	<u>(45,202)</u>
TOTAL RATE BASE	<u>\$ 5,246,243</u>

VI. CAPITAL STRUCTURE

The Company's proposed capital structure included current maturities in long-term debt. Staff's proposed capital structure omitted current maturities for long-term debt. Neither Intervenor

took issue with the proposed capital structure. Accordingly, the Commission finds that Staff's proposed capital structure should be utilized herein. This capital structure appears in the following table:

Table B
CAPITALIZATION
MARCH 31, 1994

	<u>Amount</u>	<u>Ratio</u>
Long-Term Debt	\$ 122,570,000	54.06%
Common Equity	<u>104,172,000</u>	<u>45.94%</u>
TOTAL	<u>\$ 226,742,000</u>	<u>100.00%</u>

This capital structure represents the Company's actual capital structure at March 31, 1994. (See Hearing Exhibit 19, Accounting Exhibit A-6.)

VII. COST OF CAPITAL

A. Long Term Debt

For the purposes of this proceeding, the Commission Staff computed an embedded cost ratio of 9.87% for the Company's debt. The Company determined the embedded cost to be 9.82%. Neither the Consumer Advocate nor the Energy Users took issue with the embedded cost rate. As the Commission has accepted Staff's proposed capital structure, the Commission accepts Staff's cost of embedded debt. The Commission finds Staff's embedded cost rate on long term debt to be proper for the determination of the fair and reasonable rate of return in the context of this proceeding.

B. Common Equity

One of the principle issues in a ratemaking determination involves the proper earnings to be allowed on the common equity investment of the regulated utility. In this proceeding the Commission was offered expert testimony of witnesses relating to the fair and reasonable rate of return on common equity for the Company.

Company witness Murry provided testimony and exhibits as to the appropriate cost of the Company's common equity. Dr. Murry testified that he employed the discounted cash flow (DCF) technique to estimate the cost of equity for the Company and for a group of six small gas distribution companies. The DCF analysis produced cost of equity estimates ranges from 7.64% to 12.57%. (Hearing Exhibit 13, Schedule 13.) Dr. Murry determined that the return on common equity required by the Company is 12.50% to 13.00%. According to Dr. Murry, the premium above the DCF calculations reflects some of the risks associated with such factors as United Cities' low equity ratio, its low interest coverage ratio, and the impact of FERC Order 636.

The Commission Staff's expert witness, Dr. James E. Spearman, also presented testimony and exhibits relative to the cost of equity capital. Dr. Spearman employed two independent methods, the Capital Asset Pricing Model (CAPM) and the Discounted Cash Flow (DCF), in reaching the conclusions expressed in his testimony in regard to his estimate of the rate of return on equity capital which the Company should be allowed the opportunity to earn. Dr. Spearman utilized financial data for United Cities Gas Company and

for the Moody's Gas Distribution Index. Based on the results of his analysis, Dr. Spearman concluded that the return on equity portion of rate base for the Company fell within a broad range from a low of approximately 9.0% to a high of approximately 13.0%. Dr. Spearman testified that his best estimate of the allowable return on common equity was within a range of 11.5% to 12.0%, which includes a 21 basis point adjustment for stock flotation costs.

The Commission cannot determine the fair and reasonable return on common equity for the Company in isolation. Rather, the Commission must carefully consider a variety of relevant factors, including identifiable trends in the market relating to the costs of labor, materials, and capital; comparisons of past earnings with present earnings and prospective earnings; the prices for which the Company's services must be rendered; the returns of other enterprises and the reasonable opportunities for investment therein; the financial policy and capital structure of the Company and its ability to attract capital; the competency and efficiency of the Company's management; the inherent protection against destructive competition afforded the Company through the operation of the regulatory process; and the public demand for growth and system expansion which is required to evaluate the construction program for the foreseeable future. The Commission must strike the balance among these complex factors in the context of the record herein.

The Commission recognizes the legal principle and the practical necessity that the Company be allowed the opportunity to earn a fair rate of return to enable it to continue to meet its

service obligations and to maintain its financial strength to provide for the attraction of capital.

In its determination of a fair and reasonable rate of return, the Commission maintains the ultimate responsibility of setting the rates to be charged for the utility services provided by the Company. The exercise of that responsibility involves the balancing of the interests of the consumer and the investor. The Commission must gravely balance the interests of the consumer in regard to the price of utility service with the interests of the same consumer in regard to reliability and adequacy of the supply of energy. The Commission has maintained these interests paramount throughout this proceeding. The Commission's determinations of the Company's revenue requirements and of the proper allocation of those revenues within the approved rate structure embodied in this Order reflect fairly and equitably both the interests of those consumers and the interests of the Company.

In light of all relevant issues in the record of this proceeding, and specifically, the rate of return studies of Dr. Spearman, the Commission is of the opinion, and so finds, that a fair and proper return on common equity is 11.75% - 12.00%, including flotation costs. The Commission further finds that a fair and proper return on common equity of 11.75%, including flotation costs, provides the opportunity to produce additional revenues of \$252,645 for the Company's South Carolina operations, which the Commission finds fair and reasonable.

The range of rate of return of common equity of 11.75%-12.00% herein found fair and reasonable falls within the analysis

conducted by Dr. Spearman. The Commission considers the results reached by Dr. Spearman to have incorporated effectively the expectations of the potential equity investor through the estimate of relevant risk of investment in the Company's equity relative to the market as a whole. The Commission considers Dr. Spearman's analysis to represent the reasonable expectation of the equity owner, and therefore, to be consistent with the pertinent legal standards. This range of return of 11.75%-12.00% is fair and reasonable and is sufficient to protect the financial integrity of the Company, to preserve the property of the investor, and to permit the Company to continue to provide reliable service to present and future customers at reasonable rates.

VIII. RATE OF RETURN ON RATE BASE

An important function of ratemaking is the determination of the overall rate of return which the utility should be granted. This Commission has utilized the following definition of "rate of return" in previous decisions, and continues to do so in this proceeding:

For regulatory purposes, the rate of return is the amount of money earned by a regulated company, over and above operating costs, expressed as a percentage of the rate base. In other words, the rate of return includes interest on long-term debt, dividends on preferred stock, the earnings on common stock and surplus. As Garfield and Lovejoy have put it "the return is that money earned from operations which is available for distribution among the various classes of contributors of money capital. In the case of common stockholders, part of their share may be retained as surplus."

Phillips, The Economics of Regulation, pp. 260-261 (1969).

The United States Supreme Court's landmark decision in

Bluefield Water Works and Improvement Co. v. Public Service

Commission of West Virginia, 262 U.S. 679 (1923), delineated general guidelines for determining the fair rate of return in utility regulation. In the Bluefield decision, the Court said:

What annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts. A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risk and uncertainties; but it has no constitutional rights to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time, and become too high or too low by changes affecting opportunities for investment, the money market, and business generally.

262 U.S. at 692-693.

During the subsequent years, the Supreme Court refined its appraisal for regulatory precepts. In its frequently cited Hope decision, supra, the Court restated its views:

We held in Federal Power Commission v. Natural Gas Pipeline Co. . . . that the Commission was not bound to the use of any single formula or combination of formulae in determining its rates. Its ratemaking function, moreover involves the making of "pragmatic adjustments" (cite omitted) Under the statutory standard of "just and reasonable" it is the result reached, not the method employed which is controlling (citations omitted)
. . . .

The ratemaking process under the Act, i.e., the fixing of "just and reasonable" rates involves a balancing of the investor and the consumer interest. Thus we stated in the Natural Gas Pipeline Co. case, that regulation does not insure that the business shall produce net

revenues. (citation omitted).

But such considerations aside, the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. (citation omitted). By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

320 U.S. at 602-603.

The vitality of these decisions has not been eroded, as indicated by the language of the more recent decision of the Supreme Court in In Re: Permian Basin Area Rate Cases, 390 U.S. 747 (1968). This Commission has consistently operated within the guidelines set forth in the Hope decision. See also, Southern Bell, supra, 244 S.E.2d at 280-83.

The rate of return which the Commission has herein found to be fair and reasonable should enable the Company to maintain its levels of good service and preserve its financial integrity. Patently, however, the Company must insure that its operation and maintenance expenses remain at the lowest level consistent with reliable service and exercise appropriate managerial efficiency in all phases of its operations. The Commission has consistently manifested its abiding concern for the establishment and continuation of efficiency programs on the part of its jurisdictional entities. The Commission reiterates its consistent statement that we are not inclined to be completely satisfied with

the cost reduction and efficiency programs of any jurisdictional entity. Consequently, the Commission will continue to expect the Company to design and implement such programs in the future as an index of good management practice in the interests of its customers and of the Company itself.

In this Order, we have previously found that the capitalization ratios set forth in Table B are appropriate and should be used for ratemaking purposes herein. The Commission finds that the embedded cost rate for long-term debt of 9.87% is fair and reasonable for use in this proceeding. For the purposes of this proceeding, the Commission has herein found the proper cost rate for the Company's common equity capital to be in the range of 11.75%-12.00%.

Using these findings, the overall rate of return on rate base for the Company's South Carolina operations, based on a 11.75% rate of return on equity, may be derived as computed in the following table:

Table C OVERALL RATE OF RETURN			
	<u>Ratio</u>	<u>Cost</u>	<u>Weighted Cost</u>
Long-Term Debt	54.06%	9.87%	5.34%
Common Equity	<u>45.94%</u>	11.75%	<u>5.39%</u>
Total	<u>100.00%</u>		<u>10.73%</u>

IX. Revenue Requirements.

The Company's total income for return after accounting adjustments and prior to any rate adjustment, for its South Carolina operations, is \$399,320. This amount, when divided by the Company's rate base of \$5,246,243 as calculated in Table A, produces a rate of return on rate base of 7.61%, as of March 31, 1994.

In order to achieve an overall rate of return on its South Carolina operations at the level of 10.73%, which this Commission has found to be appropriate and reasonable for the test year period for the reasons previously indicated, the Company would require additional revenues of \$252,645 from its South Carolina operations.

Total income for return, both before and after the approved increase, as found by the Commission, is illustrated as follows:

Table D
TOTAL INCOME FOR RETURN

<u>Before Rate Increase</u>	<u>Total</u>
Net Operating Income	\$ 386,189
Customer Growth	13,131
AFUDC	0
Total Income for Return	<u>\$ 399,320</u>
 <u>After Rate Increase</u>	 <u>Total</u>
Net Operating Income	\$ 544,393
Customer Growth	18,510
AFUDC	0
Total Income for Return	<u>\$ 562,903</u>

X. Allocation of Revenues.

The revenue requirements of the Company having been determined, the Commission is also concerned with the determination of the specific rates and the development of the rate structure that will yield the required revenues. It is generally accepted that proper utility regulation requires the exercise of control over the rate structure to ensure that equitable treatment is afforded each class of customer.

The three primary criteria of a sound rate structure have been set forth as follows:

. . . (a) the revenue-requirement or financial-need objective, which takes the form of a fair-return standard with respect to private utility companies; (b) the fair-cost apportionment objective which invokes the principle that the burden of meeting total revenue requirements must be distributed fairly among the beneficiaries of the service, and (c) the optimum-use or consumer rationing objective, under which the rates are designed to discourage the wasteful use of public utility services while promoting use that is economically justified in view of the relationships between costs incurred and benefits received.

Bonbright, Principles of Public Utility Rates (1961), p. 292.

These criteria stated above have been used by this Commission in past cases and are utilized again in this proceeding.

The Company's Application in this proceeding proposed to increase the Company's approved tariffs overall by approximately 3% which would have generated additional annual revenues of \$341,434. The rate schedules proposed by the Company produced variations in the percentage increase in revenues among the customer classifications. Under the proposed rate schedules, revenues from the residential class (Rate 710) would increase 7.46%; the revenues

from the Commercial Firm class (Rate 720) would increase 5.29%; the revenues from the Industrial Firm class (Rate 720) would increase 3.59%; and the revenues from the Optional class (Rate 750) would increase 0.54%.

In approving the increases in the Company's various classes of service, the Commission has undertaken to recognize and reconcile the Commission's consistent ratemaking objectives to meet the revenue requirements found fair and reasonable. The Commission has considered the revenue increases for each class of service shown in Table E, infra, and finds the same to be fair and reasonable, and appropriate for this proceeding.

Table E
APPROVED INCREASE BY CLASS

<u>Class of Service</u>	<u>Approved Increase</u>
Residential (Rate 710)	\$ 64,729
Commercial (Rate 720)	54,037
Industrial Firm (Rate 720)	111,932
Industrial Interruptable (Rate 750)	<u>21,947</u>
Total Increase	<u>\$ 252,645</u>

The Company proposed to increase the monthly customer charge (or basic facilities charge) for residential customers from \$3.00 per month per meter to \$5.00 per month per meter and for commercial customers from \$7.00 per month per meter to \$10.00 per month per meter. The Company also proposed a winter/summer rate design for residential service where the commodity charge per therm is less in the summer months than in the winter months.

The Commission finds that the basic monthly facilities charges should be increased as indicated in Appendix A, attached hereto and

incorporated herein. The Commission also approves the winter/summer rate design for residential service as indicated in Appendix A.

The Company also requested a returned check charge of \$20.00 be included in its tariff. The Commission holds that this charge is governed by S.C. Code Ann. §58-11-70 (1976, as amended).

The Company proposed to increase its reconnect charges from \$10.00 to \$25.00 where service has been disconnected at the request of the customer and reconnection of service is requested by the same customer at the same premises within one year or where reconnecting service after discontinuance of service for non-payment of bills. The Commission finds that the increase in charges as stated above is fair and reasonable and hereby approves the increased reconnect charges.

Several other rate design and tariff change requests were proffered by the Company that were unopposed and are therefore, adopted by the Commission. These changes are: (1) inclusion of a provision for a late charge of one and one-half percent (1 1/2%); (2) elimination of the existing air conditioning rate for those customers grandfathered in as of July 29, 1982; (3) inclusion of new tariffs for a School Gas Service Rate, an Economic Development Rate, a Cogeneration, CNG, Fuel Cell Service Rate and Large Tonnage Air Conditioning Rate, and an Emergency Service Rate; (4) revisions to the Company's Transportation Tariff; (5) revisions to the Gas Light Provision tariffs; and (6) modifications to the meter test deposit and charges for meter testing.

The Company also proposed revisions to its current service

line and main extension policies. The Company proposed changing its current policies with a formula approach based on estimated usage. The Commission has examined the proposed change in the service line and main extension policy and is not convinced as to the need for the proposed change. Therefore, the Commission denies the proposed change in service line and main extension policy.

The Commission has carefully considered the entire record and believes that the rates attached hereto as Appendix A are fair and reasonable.

XI. MISCELLANEOUS

The Staff investigated the implementation of a Weather Normalization Adjustment (WNA) for the Company. The Commission has approved a WNA for Piedmont Natural Gas Company and for South Carolina Electric and Gas Company. Company witness Sager testified that the small size of the Company's operations in South Carolina makes it cost prohibitive to justify implementation of a WNA. Mr. Sager testified that the costs would outweigh any benefits received from a WNA. Upon consideration, the Commission agrees with the Company that any benefits received would be outweighed by implementation and maintenance costs. Therefore, the Commission will not adopt a WNA for the Company.

In connection with the herein approved Economic Development Gas Service Tariff, the Commission believes that it is appropriate for the Company to maintain records concerning the level of discounted or incentive rates offered under the tariff as the Commission will address these discounts or incentives in the Company's next general rate proceeding.

XII. Findings and Conclusions.

Based upon the foregoing considerations and after a full review of the testimony, exhibits and complete record in this proceeding, the Commission has made the following findings and reached the following conclusions concerning the operations, the rate of return and the reasonable earnings requirements to be allowed the Company:

1. That United Cities Gas Company is a gas utility and is subject to the jurisdiction of this Commission, pursuant to S.C. Code Ann., Sections 58-5-10, et seq. (Law Co-op. 1977);
2. That the appropriate test period for the purposes of this proceeding is the twelve-month period ending March 31, 1994;
3. That the Company in its Application is seeking an increase in rates and charges to certain customers in this proceeding that will produce additional revenues for the test year period of \$341,434;
4. That an end-of-test year, original cost rate base of \$5,246,243 consisting of the components set forth in Table A of this Order should be adopted for ratemaking purposes;
5. That the capital structure set forth in Table B of the Order should be adopted for this proceeding;
6. That the rate of return on the Company's operations, during the test year, after accounting and pro forma adjustments, and prior to any rate adjustments, was 7.61%;
7. That testimony provided that a fair and proper return on common equity for the Company which will be produced by additional revenues of \$252,645;

8. That the Company's embedded cost of debt of 9.87% and a cost rate of 11.75% on common equity should be used in the determination of a fair overall rate of return;

9. That the accounting and pro forma adjustments set forth in Section IV of this Order are reasonable and proper;

10. That the total income for return after accounting and pro forma adjustments and prior to rate adjustments, was \$399,320 for the test period, and that such amount of income is insufficient based on the reasonable rate of return found in this proceeding;

11. That approval should be given for rates and charges which will provide additional gross revenues to the Company of \$252,645 on its gas operations, which will produce an additional total income for return of \$163,583;

12. That the additional revenues allowed would produce a rate of return on approved rate base of 10.73% which is found to be fair and reasonable in this proceeding;

13. That such additional revenues and the return which these revenues produce are well within the range of reasonableness and fairness and must be provided if the Company is to meet all of its customer requirements;

14. That the additional revenues would provide a rate of return on common equity of 11.75%;

15. That the Company should be allowed to earn within a range of 11.75% to 12.00% on its common equity;

16. That the schedule of rates and charges attached hereto as Appendix A should be approved for service rendered on or after the date of this Order;

17. That the Company should file with the Commission within five (5) days from the date of receipt of this Order, rate schedules which reflect the rates contained in Appendix A and tariffs reflecting the findings contained herein;

18. That the Company should continue to file with this Commission, as previously ordered, quarterly reports showing:

- a. Rate of return on rate base;
- b. Return on common equity;
- c. Earnings per share of common stock; and
- d. Debt coverage ratio of earnings to fixed charges.

IT IS THEREFORE ORDERED:

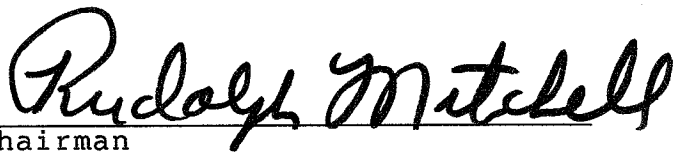
1. That the proposed rate schedules filed by the Company on August 8, 1994, are unreasonable and improper and are hereby disapproved; that the rate schedules as stated in Appendix A are reasonable and proper and are hereby approved.

2. That the rate schedules as stated in Appendix A shall be effective as of the date of this Order.

3. That the Company file all reports herein identified in accordance with the findings contained herein.

4. That this Order shall remain in full force and effect
until further Order of the Commission.

BY ORDER OF THE COMMISSION:


Chairman

ATTEST:


Executive Director

(SEAL)

DOCKET NO. 94-396-G - ORDER NO. 95-156
FEBRUARY 7, 1995
APPENDIX A

RATES EFFECTIVE FOR SERVICE ON AND AFTER FEBRUARY 7, 1995

RATE SCHEDULE 710
General Residential Gas Service

Basic Monthly Facilities Charge----- \$ 3.35
May through September----- \$ 0.1510 per therm
October through April----- \$ 0.1899 per therm

RATE SCHEDULE 720
Firm Commercial and Industrial Service

Firm Commercial Service
Basic Monthly Facilities Charge----- \$ 8.50
All Therms----- \$ 0.1027 per therm

Firm Industrial Gas Service
Basic Monthly Facilities Charge----- \$10.00
All Therms----- \$ 0.1027 per therm

RATE SCHEDULE 750
Optional Gas Service

Basic Monthly Facilities Charge----- \$25.00
All Therms----- \$ 0.0400 per therm

NOTE: Above rates do not include Exploration and Development increment
of \$.0038 per therm effective February 1, 1995.